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Before the  
**FEDERAL COMMUNICATIONS COMMISSION**  
Washington, D.C. 20554

**FCC 93-353**

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In the Matter of

Implementation of Sections of  
the Cable Television Consumer  
Protection and Competition Act  
of 1992

Rate Regulation

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MM Docket No. 93-215 ✓

**Notice of Proposed Rulemaking**

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By the Commission: Commissioner Barrett issuing a statement.

Comment Date: August 25, 1993

Reply Comment Date: September 14, 1993

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## I. Introduction

1. In this Notice of Proposed Rulemaking ("Notice"), we propose regulatory requirements to govern cost-of-service showings submitted by cable operators seeking to justify rates above levels determined under our primary method of regulating rates using benchmarks and price caps. We also delegate authority to the Mass Media Bureau to conduct cost studies of individual cable companies in conjunction with this rulemaking. We further propose a productivity offset feature that could be incorporated into our price cap mechanism governing cable service rates, and information collection requirements to implement Section 623(g) of the Cable Act of 1992.<sup>1</sup>

## II. Background

2. On May 3, 1993, the Commission released a Report and Order and Further Notice of Proposed Rule Making in MM Docket No. 92-266, FCC 93-177, 58 FR 29736 (May 21, 1993) ("Report and Order"), establishing rules to implement the cable television rate regulation provisions of the Communications Act of 1934, as amended by the Cable Television Consumer Protection and Competition Act of 1992 ("Cable Act of 1992").<sup>2</sup> The 1992 Cable Act provides that rates for cable service, other than per channel and pay-per-view services, provided by cable systems not subject to effective competition, as defined in the statute, shall be subject to regulation. The statute provides for regulation of the basic service tier generally by local franchising

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<sup>1</sup> Communications Act, Section 623(g), 47 U.S.C. Section 543(g).

<sup>2</sup> Cable Television Consumer Protection and Competition Act, Pub. L. No. 102-385, §§ 3, 9, 14, 106 Stat. 1460 (1992). The 1992 Cable Act became law on October 5, 1992.

authorities,<sup>3</sup> and of cable programming services tiers exclusively by the Commission.<sup>4</sup>

3. In the Report and Order, the Commission adopted a benchmark and price cap approach to setting rates for regulated cable services. Under that approach, existing rates for cable service are compared to a benchmark that reflects the rates charged by cable systems subject to effective competition, with a given number of subscribers, channels, and satellite channels. In general, systems with current rates above the benchmark must either lower rates to the benchmark or to the rates in effect on September 30, 1992, reduced by ten percent, whichever reduction is less.<sup>5</sup> The Commission established forms and associated instructions that determine the precise manner of conducting the benchmark comparison and reducing rates.<sup>6</sup> Once initial rates are determined by comparison to the benchmark, rates are governed on a going-forward basis by a price cap mechanism. The price cap permits annual adjustments for inflation and a recovery of increases in external costs, including programming costs, costs of franchise requirements, taxes, and franchise fees.

4. The Commission based its adoption of the benchmarking and price cap approach for regulation of cable service rates on an evaluation of the advantages and disadvantages of that approach and traditional cost-of-service regulation. The

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<sup>3</sup> The basic service tier must include: (1) all local commercial and noncommercial educational television and qualified low power station signals carried to meet carriage obligations imposed by Sections 614 and 615 of the Communications Act; (2) any public, educational, and governmental access programming required by the franchise to be provided to subscribers; and (3) any signal of any television broadcast station that is secondarily transmitted by a satellite carrier beyond the local service area of such a station. Communications Act, Section 623(b)(7)(A), 47 U.S.C. Section 543(b)(7)(A).

<sup>4</sup> A cable programming service is "any video programming provided over a cable system, regardless of service tier, including installation or rental of equipment used for the receipt of such video programming, other than (A) video programming carried on the basic service tier, and (B) video programming offered on a per channel or per program basis." Communications Act, Section 623(1)(2), 47 U.S.C. Section 543(1)(2).

<sup>5</sup> Results of an FCC-conducted survey of cable rates as of September 30, 1992 demonstrated approximately a ten percent differential between the average rates of those systems subject to effective competition and those not subject to such competition.

<sup>6</sup> See Public Notice, May 20, 1993.

Commission determined that a benchmark and price cap approach should serve as the primary method for regulation of cable service rates given the disadvantages associated with cost-of-service regulation, including increased administrative burdens imposed on cable operators and regulators.<sup>7</sup>

5. At the same time, the Commission was concerned that the benchmark and price cap regulatory framework might not in all cases permit cable operators to recover the reasonable costs of providing regulated cable service. Accordingly, the Commission established an opportunity for cable operators to justify rates above benchmark or capped levels based on costs. Although the Commission had previously proposed and sought comment on regulatory requirements to govern cost-of-service showings by cable operators, the Commission determined that the record at that time was not sufficient to permit the careful balancing of subscriber and cable operator interests that should be embodied in cost-of-service requirements.<sup>8</sup> The Commission stated that it would issue the instant Notice to gather the record necessary for adoption of cost-of-service requirements.<sup>9</sup>

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<sup>7</sup> The Commission determined that the regulatory framework for rate regulation should be "tier-neutral." The Commission found that this approach was preferable to one that could, for example, suppress rates for the basic service tier and allow higher earnings for cable programming services tiers. The Commission found that the potential benefits of a low-priced basic tier were outweighed by the fact that such an approach would create incentives for cable operators to move programming to higher tiers. The Commission also found that different rate standards for the basic and cable programming services tiers could significantly increase the complexity of rate regulation of cable service.

<sup>8</sup> In the initial Notice of Proposed RuleMaking in this docket, 8 FCC Rcd 510 (1992), we sought comment on what cost-of-service standards should be adopted to achieve the proper balance between the interests of consumers in paying a reasonable rate and of cable operators in recovering their reasonable costs and being able to continue to attract capital. See 8 FCC Rcd at 547-550. Specifically, we solicited comment on such major components of cost-of-service standards as what should be included in the operator's ratebase, the proper rate of return and cost of capital related to cable systems, depreciation, operating expenses, and the optimal degree of cost-averaging under cost-of-service regulation. Id.

<sup>9</sup> Pending adoption of rules in this proceeding, local franchising authorities for the basic tier and the Commission for cable programming services, will review cost-of-service showings by cable operators on a case-by-case basis under general cost-of-service principles.

### III. A Regulatory Framework to Govern Cost-Based Cable Service Rates

6. In this Notice, we propose to establish a regulatory framework to govern rates for cable service based on costs. This regulatory framework will consist of regulatory goals for cost-based regulation of cable service rates and the regulatory requirements that will achieve those goals. We discuss first our tentative goals for cost-based regulation of cable service rates and then the requirements that we could adopt to achieve them.

#### A. Regulatory Goals

7. As indicated, in the Report and Order, the Commission adopted a benchmark and price cap approach as the primary means of governing rates for regulated cable service. Our benchmark and price cap requirements will continue to serve as the primary mechanism for regulation of cable service rates.<sup>10</sup> We additionally intend to establish an opportunity for cable operators to justify rates based on costs, as we will explore in this proceeding. We believe that our benchmark, price cap, and cost-of-service requirements should constitute a complete regulatory approach for setting cable service rates. Thus, a goal for the cost-of-service requirements that we ultimately adopt in this proceeding will be that they form a "backstop" for the benchmark approach to rate regulation. We solicit comment on what cost-of-service requirements we should adopt that will best form this part of our comprehensive plan for regulation of cable service rates. In particular, we request comment on what rate levels our cost-based requirements should produce in relation to benchmark rates. We also solicit comment on what role generally a cost-based approach to ratemaking should play in our regulation of cable service rates. We believe that the principal purpose of cost-based ratemaking in the overall framework of our regulations should be to permit regulatory authorities to evaluate whether rates that exceed the benchmark for a specific system are nonetheless reasonable in light of that system's permissible costs, as discussed more fully below.

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<sup>10</sup> We are concurrently with the instant proceeding addressing petitions for reconsideration of the Report and Order. On reconsideration, we will be examining the role of cost-of-service requirements in our regulation of cable service rates and their relationship to benchmark and price cap requirements. We incorporate by reference petitions for reconsideration of the Report and Order. We may adopt in the instant proceeding proposals made on reconsideration concerning cost-of-service requirements and the role they should play in our overall approach for regulation of cable service rates.

8. Our regulatory framework for cost-based rates for cable service will govern the rates for cable service set pursuant to cost-of-service showings by cable operators seeking to justify rates above benchmark and capped levels. Our framework will determine the price that operators may charge for cable service and the earnings that cable operators may achieve through cost-based rates. We believe that our regulatory requirements determining cost-based rates must reflect a balancing of the interests of cable operators and consumers that is fair and reasonable to both. Our requirements should permit cable operators to recover the reasonable costs of providing cable service and to attract capital, including the opportunity for reasonable earnings, while protecting consumers from paying inappropriate costs and unreasonable charges, which was one of Congress' primary concerns when effective competition for cable is not present.<sup>11</sup>

9. Congress also identified the policy goal of ensuring that cable operators continue, where economically justified, to expand their telecommunications infrastructure.<sup>12</sup> The Commission agrees that cable operators can, and should, contribute to the continued development of an advanced telecommunications infrastructure. Cable operators have major communications capabilities in place and are rapidly making facilities and services improvements.<sup>13</sup> They are also actively exploring ways to combine existing services with new telecommunications services that could increase competition in the provision of communications services to the public and bring new services to

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<sup>11</sup> Cable Act of 1992, Section 2(b)(4).

<sup>12</sup> Id. at Section 2(b)(3); see also Telephone Company-Cable Television Cross-Ownership Rules, Sections 63.54-63.58, Notice of Inquiry, 2 FCC Rcd 5092 (1987), Further Notice of Inquiry and Notice of Proposed Rulemaking, 3 FCC Rcd 5849 (1988), Further Notice of Proposed Rulemaking, First Report and Order, and Second Further Notice of Inquiry, 7 FCC Rcd 300 (1991), recon., 7 FCC Rcd 5069, appeal pending sub. nom., National Cable Television Assoc., Inc. v. FCC, No. 91-1649 (D.C. Cir. filed Dec. 26, 1991), Second Report and Order, Recommendation to Congress, and Second Further Notice of Proposed Rulemaking, 7 FCC Rcd 5781 (1992), pets. for recon. pending, appeal pending sub. nom., Mankato Citizens Telephone Co. v. FCC, No. 92-1404, (D.C. Cir. filed Sept. 9, 1992).

<sup>13</sup> See generally, Cable Television Advertising Bureau, Cable Fact Book (1993); National Cable Television Association, 17 Cable Television Developments, (March 1993).

consumers.<sup>14</sup> We also believe that, in the near future, cable operators may experience significant competition in delivery of video programming to consumers. We believe that, consistent with the Act, our requirements should not thwart operators' ability to respond to competitive forces by means of facility and service improvements. For these reasons, we further tentatively conclude that our regulatory requirements for cost-based rates should also be designed to assure that cable operators may fully respond to incentives to provide a modern communications infrastructure and to respond to competitive forces. We believe that such an approach directly serves Congress' intent to encourage "economically justified" expansion of the cable infrastructure.

10. In the Report and Order, the Commission determined that the benchmarking process for setting rates would be based on the goal of achieving rates for cable service that approach rates of competitive systems. The Commission established a regulatory framework with procedures designed to ensure that systems with rates above the competitive benchmark will reduce rates by the competitive differential of ten percent. The Commission explicitly selected such an approach as the preferred method of rate regulation, as opposed to using traditional cost-based regulation as its primary regulatory tool. We solicit comment on whether our regulatory framework for cost-based rates should also be guided by the goal of producing rates that approximate competitive rate levels, i.e., rates that approach the operators' costs. The key distinction between the benchmark/price cap approach and the cost-based approach, however, is that operators making a cost-of-service showing are seeking to justify rates that exceed the benchmarks but that nevertheless are reasonable because they are based on costs, as determined under our requirements. We seek comment on whether this is the correct formulation of the cost-of-service objectives.

11. In the Report and Order, we also concluded that we should adopt a benchmark for regulation of cable service rates that is tier-neutral. We concluded that a regulatory framework

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<sup>14</sup> See e.g., Kupfer, The No. 1 in Cable TV has Big Plans, Fortune, June 28, 1993, at 92. Expanded Interconnection with Local Telephone Company Facilities (Report and Order and Notice of Proposed Rulemaking), CC Docket No. 91-141, 7 FCC Rcd 7369, 7373, para. 4, (1992), recon., 8 FCC Rcd 127 (1992), pets. for recon. pending, appeal pending sub nom. Bell Atlantic Corp. v. FCC, No. 92-1619 (D.C. Cir., filed Nov. 25, 1992); "Time Warner Plans Competitive Access Service in California," Telecommunications Reports, June 28, 1993, pp 8-9; Amendment of the Commission's Rules to Establish New Personal Communications Services (Notice of Proposed Rulemaking and Tentative Decision), GEN Docket No. 90-314, ET Docket No. 92-100, 7 FCC Rcd 5676 (1992).



that produced a low-priced basic service tier but that also created incentives for cable operators to move programming from the basic to higher tiers did not have any advantages over a regulatory scheme that was tier-neutral. We tentatively conclude, for the same reasons, that we should adopt standards of reasonableness of cable service rates based on costs that are also tier-neutral. We solicit comment on this tentative conclusion.

12. Determination and evaluation of cost-based rates can be a complex and resources intensive activity. In-depth evaluation of cost-based rates for many cable operators would impose significant administrative burdens on cable operators and regulators. Therefore, we believe that our requirements for cost-based rates must, to the extent possible, be based on a pragmatic approach geared to the feasibility of implementation of cost-based regulation by local regulators and the Commission. We believe that, to the extent possible, our regulations should be designed to reduce administrative burdens on cable operators and regulators.

13. We also believe that our regulations, while protecting consumers from paying unreasonable charges, should nonetheless permit the recovery of costs for providing cable service in high cost areas. Our regulations should not preclude operators facing unusual operating costs to recover such costs in rates for cable service. We will endeavor to fashion requirements that give ratemaking recognition to all legitimate costs while preventing recovery in rates of unreasonable costs.

14. Finally, we believe that the goals we adopt for fashioning regulatory requirements for cost-based cable service rates should carefully consider the potential impact of such goals and requirements on consumers and the cable industry. In order to permit the Commission to fully assess the impact of possible requirements that we could adopt in this proceeding, we seek comment on the present economic and financial performance and practices of the cable industry, including expert opinion and economic models, and on the financial and economic impact of cost-based rates on the cable industry and consumers.

#### B. Regulatory Requirements

15. In this section, we propose and discuss the regulatory requirements that could be adopted as part of our regulatory framework governing cost-based rates of cable service. These requirements will be designed and selected to achieve our balancing of goals for cost-based regulation of cable service. These possible regulatory requirements consist of the regulatory tools employed by this Commission and other federal and state regulatory bodies to govern the rates of rate regulated

industries based on costs.<sup>15</sup> We tentatively conclude that we may employ these requirements for cost-based regulation under the Cable Act of 1992.<sup>16</sup>

16. We have previously recognized the disadvantages of traditional cost-based rate regulation when regulating other telecommunication industries and have sought to develop other

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<sup>15</sup> See e.g., Amendment of Parts 65 and 69 of the Commission's Rules to Reform the Interstate Rate of Return Represcription and Enforcement Process, Notice of Proposed Rulemaking and Order, 7 FCC Rcd 4688 (1992) ("Telco Reform Notice"); Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers, Order, 5 FCC Rcd 7507 (1990) ("1990 Telco Represcription Order"), recon. denied, 6 FCC Rcd 7193 (1991), aff'd sub. nom. Illinois Bell Telephone Co. v. FCC, 988 F.2d 1254, (D.C. Cir. 1993); U.S. v. FCC, 707 F.2d 610 (D.C. Cir. 1983); FPC v. Hope Natural Gas, Inc., 320 U.S. 591 (1944); and Bluefield Waterworks v. PSC, 262 U.S. 679 (1923). Traditional rate regulation is fully acceptable under the Fifth Amendment to the United States Constitution. FPC v. Hope Natural Gas, Inc., 320 U.S. 591 (1944); and Bluefield Waterworks v. PSC, 262 U.S. 679 (1923).

<sup>16</sup> The legislative history of the Cable Act of 1992 indicates a congressional preference that the regulatory framework we adopt for governing cable rates should not closely mirror common carrier regulation. "It is not the Committee's intention to replicate Title II regulation. The FCC should create a formula that is uncomplicated to implement, administer, and enforce, and should avoid creating a cable equivalent of a common carrier 'cost allocation manual.'" House Report 102-628 at 83 ("House Report"). Although it was Congress' expectation that cable rates should not be regulated in the same manner as common carriers, we believe that our overall regulatory scheme fulfills this expectation in that the benchmarking and price cap approach is the primary method of regulating cable service rates with a secondary role played by cost-of-service regulation. In addition, as we explain, we will tailor, to the extent practicable, our procedural and other cost-of-service requirements to achieve our goals for cost-based rates of cable service. Our cost-of-service requirements for cable rates will not replicate Title II regulation. Moreover, the Cable Act of 1992 provides that the Commission shall take into account a reasonable profit in its rate regulations governing the basic service tier, and the capital and operating costs of the system in developing rates for cable programming services. Communications Act, Section 623(b)(2)(C)(vii), 47 U.S.C. Section 543(b)(2)(C)(vii). A cost of service approach is fully consistent with these statutory requirements. Accordingly, we conclude that the proposals set forth in this Notice will not contravene the statute.

alternatives.<sup>17</sup> For the same reasons, we have adopted in this proceeding a benchmark and price cap mechanism to serve as the primary method of regulating cable service rates. Accordingly, while we propose traditional concepts of cost-of-service regulation, we will endeavor to fashion a framework from them that achieves our goals and avoids to the extent possible the disadvantages of traditional cost-based regulation. We intend to adopt requirements tailored to the cable industry. We also seek alternative proposals for governing the rates of cable service based on costs, including modifications to the possible requirements discussed below. We may adopt such proposals offered by commenters even though not specifically proposed in this Notice. At paras. 70-75, *infra*, we discuss possible alternatives for streamlining cost-of-service showings.

1. Procedural Requirements for Cost-of-Service Showings

17. As indicated, in the Report and Order, we established an opportunity for cable operators to justify rates for the basic service tier and/or cable programming service tiers above levels permitted under the benchmark and price cap approach based on costs. We propose to establish limits on the frequency with which cable operators may make cost-of-service showings for the basic service tier and cable programming services tier. We propose that once a cost-of-service showing has been evaluated by either the local franchising authority or the Commission, another such showing for the tier may not be made for one year. This approach will eliminate burdens of repetitive filings and should not unduly financially affect operators because we do not anticipate that costs will change markedly within a one year period. We solicit comment on this proposal.

18. We also solicit comment on whether we should establish procedural limits or bars on cost-of-service showings seeking to justify rates higher than existing rates absent a demonstration of special circumstances or extraordinary costs. Under this approach, absent a special showing, we would not entertain cost-of-service applications to justify initial regulated rates higher than the systems' existing rates. This approach would be based on the presumption that most operators have set rates in an

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<sup>17</sup> See, e.g., Policy and Rules Concerning Rates for Dominant Carriers, Second Report and Order, 5 FCC Rcd 6786, 6787 (1990) and Erratum, 5 FCC Rcd 7664 (1990), modified on recon., 6 FCC Rcd 2637 (1991), petitions for further recon. dismissed, 6 FCC Rcd 7482 (1991), petition for recon. of ONA Part 69 Order pending appeals of LEC Price Cap Order docketed sub. nom., District of Columbia Public Service Comm'n v. FCC, No. 91-1279 (D.C. Cir. filed June 14, 1991).

unregulated environment at a level to be fully compensatory. We solicit comments on this approach and presumption.

19. In order to facilitate review of cost-of-service showings, we propose to require that in any cost-of-service showing, costs and supporting data be presented on an FCC prescribed form and associated worksheets. The form and accompanying instructions would embody the cost-of-service standards, cost allocation, and cost accounting requirements that we will adopt in this proceeding. The form would require explanations and descriptions of cost information and averaging and allocations used, to the extent not prescribed by the Commission, to permit evaluation of the showing by regulators. This form and worksheets would be used for cost-of-service showings for both the basic service tier and cable programming service tiers. We believe that use of such a form would generally reduce administrative burdens by providing for a uniform presentation of development of cost-based rates for cable service. We solicit comment on this proposal.

## 2. Cost-of-Service Standards

20. In this section, we propose cost-of-service standards that will determine both the opportunity for, and limits of, recovery from subscribers of costs incurred by cable operators. Under traditional cost-of-service regulation, rates are set at a level to provide the company with a recovery of its costs and a reasonable opportunity to earn a fair return on its invested capital. Under the traditional formulation, the company's revenue requirement is equal to the expenses of providing service and its return on investment.<sup>18</sup> In other words, the rates an enterprise is permitted to charge must be adequate to pay its expenses and earn a reasonable return on investment. We propose this traditional formulation as the overarching standard to govern cost-based rates for cable service.<sup>19</sup> We solicit comment on this proposal.

21. We address below specific requirements that could govern the expenses and return on investment that cable operators

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<sup>18</sup> Under the traditional formulation,  $R = E + (V-d)r$ , where R is the revenue requirement; E is expenses including operating expenses, maintenance expenses, depreciation and taxes; V is the value of the ratebase including plant in service and working capital; d is accumulated depreciation; and r is the rate-of-return consisting of a weighted average of long term debt, preferred stock, and common stock.

<sup>19</sup> At para. 56, *infra*, we propose that the rate-of-return of a cable company making a cost-of-service showing be measured on an investment cycle basis.

would be permitted to recover in rates for regulated cable service. We tentatively conclude that we should exclude from permitted annual expenses the expenses of providing services unrelated to provision of cable service and certain special expenses. We also tentatively conclude that the Commission should prescribe depreciation rates for cable plant and that those rates should be designed to accurately match the useful life of the plant. In addition, we tentatively conclude that we should use an original cost methodology to value cable operator's ratebase and that we should exclude excess acquisition costs from ratebase for purposes of developing cost-based rates. Finally, we tentatively conclude that we should establish a rate of return for provision of regulated cable service by all cable operators, and that we should establish a rate of return between approximately 10% - 14%, after taxes, for provision of regulated cable service, depending on the balancing of goals that we adopt in this proceeding and prevailing costs of capital. We solicit comment on whether these general requirements should form part of our regulatory framework to govern cost-based rates for cable service.

22. The foregoing or other requirements that we could adopt governing costs may constitute different costing, accounting, and financial practices for purposes of setting rates than current practices in the cable industry. They may also represent different measures of industry performance than currently used by the cable industry and lenders.<sup>20</sup> An important determinant of the standards that we adopt will be the impact on the industry and consumers. We solicit comment on the extent to which we should establish in our regulations explicit transition elements addressing the changes in financial practices and structure required by cable operators as they adapt to a rate regulated environment.<sup>21</sup> For example, as discussed below, we could allow in ratebase a portion of excess acquisition costs when evaluating the reasonableness of current rates. To the extent our cost-of-service standards will encourage most cable operators to elect the benchmarking approach to setting rates, the primary impact of these standards will be that most rates will, in fact, be set by

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<sup>20</sup> As we explain below, para. 54, we tentatively reject a cash flow analysis as the exclusive measure of financial performance of the cable industry. Rather, financial performance for ratemaking purposes will be determined by the cost-of-service requirements adopted by the Commission.

<sup>21</sup> Other regulatory agencies have established a balancing of consumer and regulated company interests that explicitly recognizes a transition for an unregulated to a regulated environment. Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, Docket No. RM87-34-065, Order No. 636, Section XI (FERC, April 8, 1992).

the benchmark approach. We seek comment on the impact of the standards that we could adopt in this proceeding. We also solicit comment on the extent to which cable service rates are already developed on the basis of costs, and the methodologies used by cable operators to do so.

a. Annual Expenses

23. We propose that a cost-based showing permit the cable operator to recover operating expenses, depreciation, and taxes as annual expenses of providing cable service. We will prohibit recovery through regulated cable rates of expenses unrelated to provision of regulated cable service.<sup>22</sup> We solicit comment on these tentative conclusions.

(1) Operating Expenses

24. Operating expenses incurred by cable operators could be expected to include plant specific costs (e.g., maintenance), plant non-specific costs (e.g., programming expense, power, engineering and testing), customer operations (e.g., marketing, billing and collection), and corporate operations (e.g., legal, planning, accounting and finance). We tentatively conclude that these costs should be included as operating expenses that cable operators are entitled to recover in rates for regulated cable service.<sup>23</sup> We believe that this will permit operators to fully recover the reasonable costs of providing service in high cost areas. We seek comment on this tentative conclusion. We also seek comment on whether other operating expenses should be recoverable.<sup>24</sup> We also tentatively conclude that we should not

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<sup>22</sup> Our cost accounting and cost allocation rules require exclusion from regulated cable service rates of those operating expenses and other costs unrelated to the provision of regulated cable service. See 47 C.F.R. Section 76.924(f) and (g).

<sup>23</sup> Section 623(c)(2)(E) of the Communications Act requires the Commission to consider, in determining the reasonableness of rates for cable programming services, operating expenses. 47 U.S.C. Section 543(c)(2)(E).

<sup>24</sup> We tentatively conclude that programming expense would be a recoverable operating expense, but would not be a cost element for inclusion in ratebase. We solicit comment on whether we should nonetheless permit a profit or mark-up on programming expense for development of cost-based rates. This could create incentives for cable operators to provide programming but would increase charges to subscribers. We solicit comment on whether cable operators will continue to have sufficient incentives to provide adequate levels of programming service without an allowed profit on programming expense.

permit recovery of certain special expenses.<sup>25</sup> Our regulations governing operating expenses will also determine the costs that must be expensed and those that must be capitalized.<sup>26</sup> We solicit comment on what costs should be expensed or capitalized.

## (2) Depreciation

25. Depreciation can affect rates in two ways. First, depreciation expense is a recurring expense that recovers in rates the cost of the depreciated asset over its useful life. Second, accumulated depreciation is the sum of depreciation previously recovered as an expense and is subtracted from gross plant to calculate the ratebase to which the prescribed rate of return is applied.

26. Under a traditional regulatory cost-of-service scheme, allowing rapid depreciation will increase the regulated company's cash flow and provide additional funds that could be used to upgrade infrastructure, although the regulated company is not necessarily obligated to use such funds for infrastructure improvements. On the other hand, rapid depreciation can increase subscriber rates. In the cable context, depreciation may be a significant expense in current development of rates for cable service; thus, limits on depreciation expense could significantly reduce the annual expenses that could be recovered in rates for cable service. Depreciation practices, therefore, could play a significant role in our balancing of goals for cost-based rates of cable service. At the same time, current depreciation practices may vary widely across the industry. Thus, depreciation requirements could have a significant impact on the industry.

27. We tentatively conclude that we should prescribe depreciation rates for purposes of developing cost-based rates for regulated cable service. This prescription could be an

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<sup>25</sup> Specifically, we propose to exclude lobbying expenses, contributions for charitable, social or community welfare purposes, membership fees and dues in social, service and recreational or athletic clubs and organizations, and penalties and fines paid on account of violations of statutes and rules. Our rules presumptively exclude these costs from costs-of-service for rates for telephone interstate access service. See 47 C.F.R. Section 32.7370.

<sup>26</sup> Costs that are expensed may be recovered in the year incurred. Costs which are capitalized are included in ratebase. The regulated company may recover a portion of the capitalized cost each year as a depreciation expense and may earn the specified rate-of-return on the capitalized cost, less accumulated depreciation, included in ratebase.

industry-wide depreciation rate or band of reasonable rates, or individual rates for each plant category.<sup>27</sup> We could also require cable operators to use company-wide expense as reported in Securities and Exchange Commission ("SEC") financial statements,<sup>28</sup> link depreciation to the specific circumstances in each franchise, or adopt some other standard. We seek comments on these alternatives. Comments favoring prescription should further address the number of depreciable plant categories and the evidence that should be taken into account in setting rates. We also solicit comment on whether we should prescribe recovery on a straightline remaining life basis,<sup>29</sup> or some other recovery methodology. If we determine that we should prescribe depreciation rates, we tentatively conclude that depreciation should be based on the book value of the asset as opposed to its economic or fair market value. We solicit comment on this conclusion.<sup>30</sup>

28. We further tentatively conclude that any depreciation rates we prescribe should be designed to accurately reflect, and recover the costs of the asset over, its useful life. We believe that this will best balance subscriber and operator interests. We solicit comment on what the impact on cable rates would be if we prescribed for the purpose of a cost of service showing depreciation schedules designed to allow recovery of capitalized costs over the maximum reasonable expected life of the plant. We seek comment on current industry depreciation practices, including the number of classes of depreciable plant, service lives, retirement schedules and depreciation methods

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<sup>27</sup> In the event that we prescribe individual rates for each plant category, we would likely need to determine and allocate existing accumulated depreciation.

<sup>28</sup> This method has the problem of setting a separate depreciation rate schedule for companies that are privately held and are not required to file schedules with the SEC.

<sup>29</sup> Under a straightline, remaining life approach, the depreciation rate is calculated under the following formula: Depreciation Rate =  $100\% \text{ Book Value} - \text{Accumulated Depreciation} - \text{Salvage\%} / \text{Average Remaining Life}$ . We seek comment on how salvage value should be determined.

<sup>30</sup> The Commission will consider in this proceeding, whether to require that the ratebase be valued for ratemaking purposes at original cost. If the original cost ratebase is adopted, comment is sought on the impact of using existing book reserves (which may or may not reflect original cost and which may reflect use of accelerated depreciation methods), as well as the impact of prescribing depreciation rates on the basis of expected remaining service life.



(e.g., straightline, accelerated). We solicit comment on the useful life and salvage value of all categories of facilities used by cable operators to provide regulated cable service.

29. As an alternative to prescription of depreciation practices, we solicit comment on whether we should for the time being only monitor operator depreciation practices. This monitoring could be facilitated by requiring cable operators to explain and justify depreciation practices in cost-of-service showings and/or by requiring reporting of depreciation practices under our collection of information requirements.<sup>31</sup> This approach could reduce administrative burdens on the Commission and cable operators, but may involve a heightened risk of higher rates for cable subscribers. We solicit comment on this alternative.

### (3) Taxes

30. We propose to allow, in determining a cable operator's annual expenses,<sup>32</sup> taxes incurred in the provision of regulated cable services.<sup>32</sup> This would include all state and federal taxes on the provision of cable service and on income taxes attributable to the provision of regulated cable service. We solicit comment on this conclusion.

#### b. Ratebase

31. As indicated, we propose to permit cable operators to recover in rates for cable service a return on the investment -- i.e., ratebase -- used to provide regulated cable service. Our regulatory requirements concerning ratebase are likely to have a significant impact on cost-based rates for cable service. We tentatively conclude that cable operators should be permitted to include in ratebase: (1) plant in service, (2) plant held for future use within a reasonable period of time, and (3) working capital, for the purpose of developing cost-based rates.

#### (1) Plant in Service

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<sup>31</sup> We discuss collection of information requirements at paras. 87-90, infra.

<sup>32</sup> Taxes would include only those payable by the business entity. Income taxes payable on income from cable operations by individual owners, partners or Subchapter S Corporation owners would not be recoverable rates for regulated cable service. We note that the Cable Act requires the Commission, in establishing its rate regulations for basic service, to take into account taxes and for cable programming service to take into governmental costs. See Communications Act, Sections 623(b) (2) (C) (5) and (c) (2) (A), 47 U.S.C. Sections 543(b) (2) (C) (5) and (c) (2) (A).

32. Plant in service is likely to be the largest portion of ratebase. We seek comment generally on what standards we should employ to determine costs that may be included in plant in service. In other rate regulated industries, the costs that the regulated company may include in the ratebase have been determined by applying the used and useful and prudent investment standards to the original construction cost of the assets dedicated to service.<sup>33</sup> We tentatively conclude that we should adopt these standards to govern the costs that may be included in plant in service.<sup>34</sup> We seek comment on this tentative conclusion.

33. Valuation of Plant in Service. We propose to establish standards to determine the value of plant in service that cable operators may include in ratebase. The value of the plant in service will be a major determinant of the level of costs that operators will be entitled to recover in rates. A number of approaches have been, or could be, used to determine the value of plant included in ratebase: market value,<sup>35</sup> original cost,<sup>36</sup>

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<sup>33</sup> The Commission has applied the used and useful standard to communications common carriers under rate of return regulation. See American Telephone and Telegraph Co., 64 FCC 2d 1 (1977), recon. in part 67 FCC 2d 1429 (1979); and American Telephone and Telegraph Co., 9 FCC 2d 30 (1967) (interim decision), aff'd on recon. 9 FCC 2d 960 (1967). For a discussion of basing utility rates on used and useful assets see Reagan v. Farmer's Loan and Trust Co., 154 U.S. 362 (1894); Stone v. Farmer's Loan and Trust Co., 116 U.S. 307 (1886); Munn v. Ill., 94 U.S. 113, 134 (1877). For a discussion of the valuation of used and useful assets as net investment in plant and property see Los Angeles Gas and Electric Co. v. Railroad Comm'n of Cal., 289 U.S. 287 (1933); Simpson v. Shepard (Minnesota Rate Cases), 230 U.S. 352 (1913); and San Diego Land and Town Co. v. National City, 174 U.S. 739 (1899).

<sup>34</sup> These standards allow into the ratebase portions of the plant that are currently, or will shortly, benefit the ratepayer, and would exclude any imprudent, fraudulent, or extravagant outlays.

<sup>35</sup> Under a market value approach, plant in service would be valued at the fair market value of assets at the time they are acquired.

<sup>36</sup> The original cost approach of valuation of plant for ratebase purposes can best be defined as the initial construction cost of the property, adjusted for all subsequent capital transactions including depreciation, retirements, and improvements. This could be a relatively simple approach to apply because cable operators and regulators can base determinations on accounting records. The results of this approach are also not

replacement cost,<sup>37</sup> and reproduction cost,<sup>38</sup> or a combination of these approaches. Under applicable judicial precedent, regulators have wide discretion to select a methodology for purposes of valuating ratebase,<sup>39</sup> and we will select an approach consistent with that precedent that best implements our balancing of goals for cost-based rates of cable service. We request comments on each approach to valuing plant used and useful in the provision of regulated cable service. We also solicit comment on how each methodology would affect systems under original ownership, and those that have been refinanced or rebuilt. We also seek comment on whether the Commission should adopt one valuation methodology for determining initial regulated rates determined by a cost-of-service showing and another for assessing proposed increases in rates of regulated cable services under subsequent cost-of-service showings.

34. Our balancing of regulatory goals for cost-based rates for cable service will determine the valuation methodology that we select for plant in service. An original cost methodology might produce the lowest rates for consumers, and would additionally permit cable operators to fully recover the costs incurred to construct the plant used and useful in provision of regulated cable service. On the other hand, a replacement methodology might encourage operators to employ new technologies.

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affected by economic conditions, making it somewhat easier to determine. It also facilitates the prescription of depreciation rates by fixing the objective as the recovery of the actual cost of construction of the cable system. However, where adequate accounting records have not been kept, this approach may be more difficult to apply.

<sup>37</sup> Under a replacement cost approach, plant would be assigned a value of the cost of building a new "state of the art" facility. This approach, with appropriate safeguards and commitments from the operator, could promote infrastructure development. In addition, where new technology and efficiencies have made provision of current levels of service with new technology less expensive than the cost of existing plant, this could result in savings to consumers.

<sup>38</sup> Reproduction cost is the present cost to construct the plant that is in service. This approach has been favored by regulators in several instances. See e.g., Bluefield Waterworks & Improvement Co. v. Public Service Comm'n of West Va., 262 U.S. 679 (1923); Stanislaus County v. San Joaquin & King's River Co., 192 U.S. 201 (1904).

<sup>39</sup> See Duquesne Light Co. v. Barasch, 488 U.S. 299, 310 (1989); Fed'l Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591, 602 (1944).

Our choice of valuation methodology may also affect the amount of "excess" acquisition costs that could be disallowed from ratebase, discussed below, for those operators that purchased a cable system for amounts in excess of the value of the plant in service. Our valuation methodology could thus have a significant impact on the industry which, in turn, will affect subscribers.

35. We tentatively conclude that we should adopt an original cost methodology to determine the value of a cable operator's plant in service for ratebase purposes. As indicated, this may produce lower rates for consumers while permitting cable operators to recover the costs incurred, by the current operator or the previous owner, in constructing assets used to provide cable television service. At the same time, this approach does not necessarily preclude recovery of excess acquisition costs, as discussed below, to the extent we permit excess acquisition costs to be included in ratebase or amortized over a specified number of years. We solicit comment on this tentative conclusion.

36. Excess Acquisition Costs. Cable operators that have purchased cable systems in an unregulated environment may have paid a price for the enterprise as an ongoing business that exceeded the value of the plant in service that would be permitted under the valuation methodology that we select for plant in service, i.e., for such operators there will be an "excess" acquisition cost.<sup>40</sup> Traditionally, excess acquisition costs have been excluded from the ratebase of regulated concerns, at least in part, because they are seen as inappropriate costs for the ratepayer to bear.<sup>41</sup> This is because the premiums from excess acquisition costs directly benefit the seller, not the ratepayer, since they do not contribute to the plant supporting service to consumers.<sup>42</sup> We note that subscribers may benefit indirectly from the sale if the purchaser is able to realize operating efficiencies that are unobtainable by the seller, but this is not likely to be the case where competition does not

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<sup>40</sup> The expression "excess" acquisition cost compares the cost of acquiring a cable system with the value of the plant, regardless of the valuation methodology selected. It does not necessarily imply that the acquisition cost was "excessive" or imprudent. While a comparatively high acquisition cost may reflect the expectation of monopoly profits, it may also be consistent with the estimation of market value, (measured by multiples of cash flow) or similar businesses (e.g., broadcast stations) subject to transactions during the same period.

<sup>41</sup> E.g., 47 C.F.R. Section 32.2007; San Diego Land & Town Co. v. National City, 174 U.S. 739, 757-758 (1899).

<sup>42</sup> See e.g. Simpson v. Shepard (Minnesota Rate Cases), 230 U.S. 352, 454 (1913).

exist, since premiums may reflect an expectation of monopoly earnings. Generally, where competition does not exist, the presumption is that premiums reflect an expectation of monopoly earnings.

37. The legislative history of the Cable Act of 1992 reveals a congressional concern that excess acquisition costs may reflect the undue market power of cable operators not subject to effective competition, which has enabled the industry to charge rates higher than would be possible in a more competitive environment.<sup>43</sup> We seek comment on whether Congress intended that we disallow excess acquisition costs.

38. Some or all of the acquisition costs in excess of original, replacement, or reproduction cost would ordinarily be considered goodwill for accounting purposes. We solicit comment on the extent to which cable operators may reasonably assign a portion of the purchase price of a cable system in excess of value of the plant in service, as determined under the valuation methodology that we select, to intangible assets such as customer lists or franchise rights. We solicit comment on how such assignments should be determined and whether we should establish limits on cable operators' discretion to do so.

39. We also solicit comment on the appropriate treatment of excess acquisition costs, including any portion thereof that can appropriately be assigned to intangible assets such as goodwill, customer lists, and franchise rights. As indicated, the traditional practice in rate regulation is to disallow excess acquisition costs from ratebase. On the other hand, it may be appropriate in some cases to allow such costs, at least in part. Where company policy has resulted in expense recognition of expenditures that produced value, still retained in the company, such as in development of customer lists, it could be appropriate to recognize that value.<sup>44</sup> It thus may be appropriate to allow

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<sup>43</sup> In assessing the market power of cable, the Senate Report used Tobin's "Q" ratio, i.e., the ratio of market value of a company to the replacement cost of the assets. Under this approach, any ratio greater than one indicates the existence of market power. The Committee took note of the fact that the selling prices of cable systems in the 1980s far exceeded their replacement costs. Senate Report 102-92, at 8-11; see also id. at 73-76 (discussing the rate regulation provisions of the Cable Act of 1992).

<sup>44</sup> There may have been various and substantial expenditures by many operators which, as a matter of company policy or as a result of application of conservative accounting practices, have been expensed even though they have effectively resulted in the creation of assets with future economic value. One such area where this may

such amounts in ratebase or to recognize their amortization as a recoverable operating expense. We solicit comment on whether we should permit this treatment of intangible assets. In addition, an equitable balancing of consumer and cable operators interests may require an allowance in ratebase of some excess acquisition costs in view of the transition of the industry from a nonregulated to a regulated environment.

40. We tentatively conclude that the best balancing of our goals for cost-based rates will be achieved by exclusion of excess acquisition costs from ratebase, including portions assigned to goodwill, customer lists, franchise rights, and other intangible assets. To the extent cable operators on the record of this proceeding can demonstrate a need to allow such costs in ratebase as a transition mechanism or that such costs represent a value to the subscriber, we may alter this conclusion. We seek comment on this tentative conclusion, and on its potential impact on the cable industry, subscribers, and lenders.

41. To the extent that excess acquisition costs are disallowed from ratebase, we solicit comment on whether we should

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be true is in the early marketing efforts of operators to develop their customer base. We recognize there may have been substantial expenditures in this activity resulting in a subscriber list, the cost of which will be recovered only as the industry begins to mature. Likewise the expenditures to obtain franchise and operating rights, though wholly or substantially written off early on, can be considered to be still beneficial in that companies are still operating under such rights. Similarly, the application of certain depreciation practices may have resulted in a general undervaluation of property, plant and equipment on the books of cable operators as the industry comes under regulation. We note that large financial losses are common across the industry and that write-offs of various organizational and development costs, and accelerated depreciation practices, appear to be at least partly responsible for the accumulation of those losses. It may be reasonable to view such accumulated losses as capital invested with an expectation of recovery over future periods as the industry reaches maturity. We seek comment on the appropriate treatment of accumulated losses. Should losses be amortized over some future period and should a return be allowed on such unrecovered amounts until they are fully recovered? Further, should there be some provision for recovery of the return foregone in past years on unrecovered expenditures, and should the amount provided reflect a reduction for tax benefits received? Are there specific elements, e.g., the subscriber list, for which such provision should be made, but others for which no special provision should be made? And, if consideration is to be given to previously written off expenditures for customer lists, franchise rights, and other organizational items, how shall they be valued now?

allow the amortization of such costs over time as an annual expense.<sup>45</sup> We also seek comment on the appropriate amortization period. We note that an extended period, e.g., 40 years, would have the effect of producing the lowest subscriber rates. We seek comment on whether cable operators require a more rapid recovery of excess acquisition costs, either permanently or as a transition mechanism.

**42. Plant Under Construction.** We solicit comment on whether we should impose any limits on inclusion of plant under construction in ratebase. We also seek solicit comment on what practices the cable industry currently follows in accounting for plant under construction. Moreover, we seek comment on whether the Commission should apply the traditional rule under ratebase/rate-of-return regulation that plant under construction will be withheld from ratebase until it meets the used and useful test, but that interest during construction can be capitalized.

**43. Excess Capacity, Cost Overruns and Premature Abandonments.** We also seek comment on whether the Commission should require exclusion from ratebase of costs incurred by a cable operator that represent excess capacity, cost overruns and premature abandonment. We solicit comment on whether these areas require regulatory limitations or whether we can monitor industry practices and impose requirements later if necessary.<sup>46</sup> To the extent we permit any of these costs in ratebase, we solicit comment on several options for doing so.<sup>47</sup>

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<sup>45</sup> In addition, to the extent any intangible assets are permitted in ratebase, we solicit comment on what amortization period should be required for such assets.

<sup>46</sup> Our rules do not permit recovery of the costs of abandoned construction projects in rates for interstate services provided by telephone companies. See 47 C.F.R. Section 32.7370(e).

<sup>47</sup> There are several ways that the Commission could treat excess capacity, cost overruns and premature abandonments for ratebase purposes. For example, we could permit the entire cost to be included in ratebase. This would allow the cable operator to recover capital and a return on capital. This option shifts all risk on to the consumer. Or, we could exclude from ratebase any costs that represent excess capacity, cost overruns and premature abandonments. This would reduce costs that must be borne by subscribers but could discourage operators from undertaking the risks of making facility improvements. As an intermediate approach, we could permit depreciation or amortization of the costs of excess capacity, cost overruns and premature abandonments but exclude them from ratebase. This would allow operators to recover such costs over time but would not allow an annual investment return on them. Should we permit amortization of such costs, we

## (2) Working Capital

44. As indicated, we propose to permit cable operators to include working capital in ratebase. Working capital is funding supplied by investors to support the regulated operation between the time the operator pays its creditors and the time it receives payment from its customers. Working capital can be either a negative or positive amount. We request comment on whether the cable industry generally incurs a negative or positive working capital requirement in its provision of regulated cable service. We also note that, traditionally, cost of service regulation has required that the leads and lags associated with payments should be analyzed in determining working capital. We recognize that this is an arduous task for most companies.

45. One approach to handling working capital would be to determine an industry-wide working capital allowance. Another would be to allow individual operators to use a balance sheet approach to determine working capital. This would require a determination of the average difference between current assets and current liabilities. Alternatively, we could require that cable operators study the timing of operating revenues and disbursements (a lead/lag study) to determine the amount of working capital included in ratebase. This would be more burdensome than a simple balance sheet determination of working capital but could more closely reflect the amount of working capital contribution from investors necessary for operation of the business. This is because a lead/lag study will reveal the extent to which revenues received prior to disbursements can meet working capital needs. We solicit comment on each of these approaches.

### c. Rate-of-Return

46. As noted above, we propose to permit cable operators to recover in rates for regulated cable service a reasonable return on investment used and useful in providing regulated cable service. We tentatively conclude that it will not be possible, as a practical matter, to establish a separate rate of return for provision of cable service within each franchise area or for each cable company. While providing for a determination of separate rates of return for each franchise area or company might permit the most accurate balancing of subscriber and operator interests, this advantage is outweighed by the increased burden on local

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solicit comment on the appropriate time period. In any amortization, we also seek comment on whether the return of capital should be defined to include both equity and debt capital or only debt expense. We tentatively conclude that it should include only debt expense.



franchise authorities, cable operators, and the Commission of developing myriad rates-of-return.<sup>48</sup> Nor do we believe that the factors on which a rate-of-return is based are likely to be so different that it is necessary to establish separate rates-of-return. Accordingly, in this informal notice and comment rulemaking proceeding we propose to establish a single rate-of-return for provision of regulated cable service by all cable operators for the purpose of setting rates based on a cost-of-service showing.<sup>49</sup> We solicit comment on this analysis and proposal. However, we further solicit comment on the alternative of establishing rates-of-return for groups or types of cable operators based on the major considerations that can guide establishment of rates-of-return. This could provide for variations to the industry rate of return based on appropriate factors. We solicit comment on what these factors would be and how this approach could be constructed.

47. The rate-of-return that we establish in this proceeding will be determined primarily by the balancing of the goals that we select, discussed above, for cost-based rates for regulated cable service. As we noted above, Congress declared the policy of the Act to include both the protection of consumers and the economically justified expansion of cable infrastructure. We seek comment on how to balance those goals in fixing the rate of return level. If the primary goal is ensuring that subscribers pay rates that are consistent with a competitive level, for example, we may select a relatively lower rate-of-return within the "zone of reasonableness" in which ratepayer interests are protected. Alternatively, if we want primarily to encourage reinvestment in infrastructure, we may select a relatively higher rate-of-return, within the zone of reasonableness.

48. In addition, we believe that the rate-of-return we select must be based on a careful analysis of the considerations

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<sup>48</sup> Most cable customers are served by franchises that are not stand-alone, discrete units either operationally or financially. It appears that there are no well accepted and readily calculable methods for isolating the business and financial risks associated with an individual franchise regulated cable service. We are particularly concerned about the difficulties of identifying and valuing the financing supporting an individual franchise.

<sup>49</sup> Because prescription of a rate of return is rulemaking, not adjudication, under the Administrative Procedure Act, we believe simple notice and comment is sufficient for prescription proceedings. See 5 U.S.C. Section 551(4), (5), (7); AT&T v. FCC, 572 F.2d 17 (2d Cir. 1978); Nader v. FCC, 520 F.2d 182 (D.C. Cir. 1972); see also Vermont Yankee Nuclear Power Corp. v. National Resources Defense Council, 435 U.S. 519 (1978); United States v. Florida East Coast Railway Co., 410 U.S. 224 (1973).